

CITY OF MORGAN HILL

CITY COUNCIL POLICIES AND PROCEDURES

CP-07-03

SUBJECT: CAPITAL FINANCING AND DEBT MANAGEMENT

EFFECTIVE DATE: June 14, 2007, REVIEWED June 27, 2007

REVISION DATE: N/A

**ORIGINATING DEPARTMENT: FINANCIAL POLICY COMMITTEE/
FINANCE DEPARTMENT**

PURPOSE

The primary purpose of this policy is to provide guidance on capital financing and debt management.

POLICY

A. Capital Financing

1. The City will consider the use of debt financing only for one-time capital improvement projects and only under the following circumstances:
 - a. When the project's useful life will exceed the term of the financing.
 - b. When project revenues or specific resources will be sufficient to service the long-term debt.
2. Debt financing will not be considered appropriate for any recurring purpose such as recurring operating and maintenance expenditures. The issuance of short-term instruments such as revenue, tax, or bond anticipation notes is excluded from this limitation because such borrowings would be issued for a short period of time in anticipation of a scheduled revenue stream that would repay the notes.
3. Capital improvements will be financed primarily through user fees, service charges, assessments, special taxes or developer agreements when benefits can be specifically attributed to users of the facility. Accordingly, development impact fees should be created and implemented at levels sufficient to ensure that new development pays its fair share of the cost of constructing necessary community facilities.
4. Development impact fees and residential development control system fees are major funding sources in financing City improvements. However, revenues from these fees are subject to significant fluctuation based upon the rate of new development. Accordingly, the following guidelines will be followed in designing and building projects funded with development impact fees or Measure C fees:

- a. The availability of fees in funding a specific project will be analyzed on a case-by-case basis as plans and specifications or contract awards are submitted for City Manager or City Council approval.
 - b. If adequate funds are not available at that time, the City Council will make one of two determinations:
 - 1) Defer the project until funds are available.
 - 2) Based on the high-priority of the project, advance funds from other available City Funds. Repayment of advances and related interest will be the first use of development impact and Measure C funds when they become available.
5. The City should consider internal borrowing prior to issuing bonds if feasible. The following are to be considered before making such internal loans:
 - a. The funds borrowed must not be needed for their intended purposes during the period in which the loan will be outstanding, as certified by City staff.
 - b. Loans will accrue interest at the rate earned by the City on Local Agency Investment Fund (LAIF) investments.
 - c. The cost effectiveness of internal financing compared to external financing opportunities must be analyzed. In general, smaller financings are good candidates for internal financings because costs of issuance would be relatively high on smaller financings, while larger financings are better candidates for external financing.
 - d. In no case shall internal borrowing be contrary to established City reserve policies.
 - e. In evaluating debt capacity, General Fund annual debt service payments should generally not exceed 5% of the General Fund currently budgeted revenues, excluding transfers in.
6. The City will use the following criteria to evaluate pay-as-you-go versus long-term financing in funding capital improvements:

Factors Favoring Pay-As-You-Go Financing

- a. Current revenues and adequate fund balances are available or project phasing can be accomplished.
- b. Existing debt levels adversely affect the City's credit rating.
- c. Market conditions are unstable or present difficulties in marketing.

Factors Favoring Long-Term Financing

- d. Revenues available for debt service are deemed sufficient and reliable so that long-term financings can be marketed with investment grade ratings.
- e. The project securing the financing is of the type which will support an investment grade rating.

- f. Market conditions present favorable interest rates and demand for City financings.
- g. A project is mandated by state or federal requirements, and resources are insufficient or unavailable.
- h. The project is immediately required to meet or relieve capacity needs and current resources are insufficient or unavailable.
- i. The life of the project or asset to be financed is 10 years or longer.

B. Debt Management

1. The City will not obligate the General Fund to secure long-term financings except when marketability can be significantly enhanced.
2. An initial feasibility analysis will be prepared for each long-term financing which analyzes the impact on current and future budgets for debt service and operations.
3. This analysis will also address the reliability of revenues to support debt service.
4. The City will generally conduct financings on a competitive basis. However, negotiated financings may be used due to market volatility, size of the financing, introduction of new credit structures to the market, or appropriate use of an unusual or complex financing or security structure.
5. The City will seek an investment grade rating (Baa/BBB or greater) on any direct debt and will seek credit enhancements such as letters of credit or insurance when necessary for marketing purposes, availability, and cost-effectiveness.
6. The City will monitor all forms of debt annually when the City Budget is prepared and will report any concerns and remedies to the City Council.
7. The City will diligently monitor its compliance with bond covenants and ensure its adherence to federal arbitrage regulations.
8. The City will maintain good, ongoing communications with bond rating agencies about its financial condition. The City will follow a policy of full disclosure of appropriate and material information on every financial report and bond prospectus (Official Statement).

C. Debt Structure

In general, debt should be structured with fixed interest rates. However, for financings of more than \$30 million (principal only) variable rate bonds and swaps should be considered if the City's financial advisor provides guidance that such debt vehicles would be safe and cost effective for the City.

D. Debt Capacity

1. **General Purpose Debt Capacity.** The City will carefully monitor its levels of general-purpose debt. Because the City's general purpose debt capacity is limited, it is important that it use only general purpose debt financing for high-priority projects where the City cannot reasonably use other financing methods for two key reasons:
 - a. Funds borrowed for a project today are not available to fund other projects tomorrow.
 - b. Funds committed for debt repayment today are not available to fund operations in the future.

In evaluating debt capacity, General Fund annual debt service payments should generally not exceed 5% of the General Fund currently budgeted revenues, excluding transfers in. Staff shall report on the current percentage of annual debt service payments compared to revenues within the General Fund in each monthly City Finance and Investment Report.

2. **Enterprise Fund Debt Capacity.** The City will set enterprise fund rates at levels needed to fully cover debt service requirements as well as operations, maintenance, administration, and capital improvement costs. The ability to afford new debt for enterprise operations will be evaluated as an integral part of the City's periodic rate review and setting process.

E. Independent Disclosure Counsel

The City should retain the services of an independent disclosure counsel in conjunction with specific project financings when the City's financial advisor, bond counsel, or underwriter recommends that the City retain an independent disclosure counsel based upon the circumstances of the financing. In general, the City should hire independent disclosure to prepare the bond prospectus (Official Statement) so that all material information is disclosed to investors.

F. Independent Financial Advisor

The City should hire a financial advisor for all external financings in excess of \$500,000. The Financial Advisor will provide guidance regarding the structuring of the financing, and coordinate the sale of the bonds so that the City will pay the lowest true interest cost.

G. Land-Based Financings

1. **Public Purpose.** There will be a clearly articulated public purpose in forming an assessment or special tax district in financing public infrastructure improvements (excluding Redevelopment Agency). If this public purpose relates to economic development in the City, then this financing should be discussed by the Community and Economic Development Committee and a recommendation concerning this purpose should be made to the City Council. In addition, the City Council should make a finding as to why this form of financing is preferred over other funding options such as reimbursement agreements; or direct developer responsibility for the improvements.

2. **Active Role.** Even though land based financings may be a limited obligation of the City, the City will play an active role in managing the district. This means that the City will select and retain the financing team, including the financial advisor, bond counsel, trustee, appraiser, disclosure counsel, assessment engineer, and underwriter, if applicable. Any costs incurred by the City in retaining these services or for staff time will generally be the responsibility of the property owners or developer and will be advanced via a deposit when an application is filed. Alternatively, these costs may be paid on a contingency fee basis from the bond proceeds.
3. **Credit Quality.** When a developer requests a district, the City will carefully evaluate the applicant's financial plan and ability to carry the project, including the payment of assessments and special taxes during build-out. This may include detailed background, credit, and lender checks, as well as the preparation of independent appraisal reports and market absorption studies. Any costs incurred by the City in retaining these services or for staff time will generally be the responsibility of the property owners or developer and will be advanced via a deposit when an application is filed. Alternatively, these costs may be paid on a contingency fee basis from the bond proceeds. For districts where one property owner accounts for more than 25% of the annual debt serviced obligation, a letter of credit further securing the financing may be required.
4. **Reserve Fund.** A reserve fund should be established in the lesser amount of: the maximum annual debt service; 125% of the annual average debt service; or 10% of the original bond principal (industry standard).
5. **Value-to-Debt Ratios.** The minimum value-to-debt ratio shall be at least 3 to 1. This means that the value of the property in the district, with the public improvements, should be at least three times the amount of the assessment or special tax debt.
6. **Capitalized Interest During Construction.** Decisions to capitalize interest will be made on a case-by-case basis, with the intent that if allowed, it should improve the credit quality of the bonds and reduce borrowing costs, benefiting both current and future property owners.
7. **Maximum Burden.** Annual assessments (or special taxes in the case of Mello-Roos or similar districts) should generally not exceed 1% of the projected sales price of the fully developed property.
8. **Benefit Apportionment.** Assessments and special taxes will be apportioned according to a formula that is clear, understandable, equitable, and reasonably related to the benefit received by, or burden attributed to, each parcel with respect to its financed improvement. Any annual escalation factor should not exceed the greater of 2% or the projected change in the consumer price index.
9. **Special Tax District Administration.** In the case of Mello Roos or similar special tax districts, the total maximum annual tax should not exceed 110% of annual debt service. The rate and method of apportionment should include a back-up tax in the event of significant changes from the initial development plan, and should include procedures for prepayments.

10. ***Foreclosure covenants.*** In managing administrative costs, the City will establish maximum delinquency amounts per owner, and for the district as a whole, before initiating foreclosure proceedings.
11. ***Disclosure to Bondholders.*** In general, each property owner who accounts for more than 10% of the annual debt service or bonded indebtedness should provide ongoing disclosure information annually as described under SEC Rule 15 (c) 2-12.
12. ***Disclosure to Prospective Purchasers.*** Full disclosure about outstanding balances and annual payments should be made by a property seller to prospective buyers at the time that buyers bid on the property.

H. Conduit Financings

1. The City will consider requests for conduit financing on a case-by-case basis using the following criteria:
 - a. The City's bond counsel will review the terms of the financing and render an opinion that there will be no liability to the City in issuing the bonds on behalf of the applicant.
 - b. There is a clearly articulated public purpose in providing the conduit financing.
 - c. The applicant is capable of achieving this public purpose.
2. The review of requests for conduit financing will be a two-step process:
 - a. First asking the Council if they are interested in considering the request and establishing the ground rules for evaluating it; and
 - b. Then returning with the results of this evaluation, and recommending approval of appropriate financing documents if warranted.

This two-step approach ensures that the issues are clear for both the City and applicant, and that key policy questions are answered.

3. The work scope necessary to address these issues will vary from request to request and will have to be determined on a case-by-case basis. Additionally, the City should generally be fully reimbursed for our costs in evaluating the request. However, this should also be determined on a case-by-case basis.

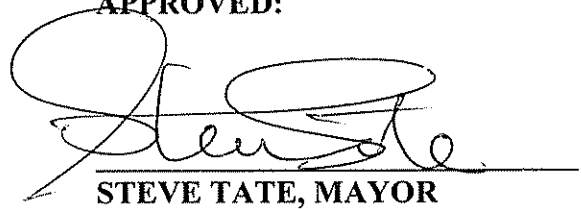
I. Redevelopment Financings

1. The Agency shall finance Redevelopment Agency projects with Tax Allocation Bonds within the constraints of the current Redevelopment Plan, whenever appropriate and whenever insufficient resources are on hand, consistent with the timing of projects approved by the Redevelopment Agency Board.

2. When issuing Tax Allocation Bonds, the Agency shall use a financial advisor, bond counsel, disclosure counsel, underwriter (for a negotiated sale), and other consultants who are experts in the issuance of redevelopment financing instruments.
3. Tax Allocation Bonds shall be issued in a manner that is the least expensive to the Agency on a present value basis, considering all projected cash inflows (such as tax increment) and cash outflows. For instance, multiple series of bonds, rather than one series of bonds, may be issued if this would be less expensive for the Agency.
4. Debt Management and Debt Structure for Tax Allocation Bonds shall be consistent with the requirements described in sections B and C above.

This policy shall remain in effect until modified by the City Council.

APPROVED:



STEVE TATE, MAYOR